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Abstract

Purpose – The current emphasis in anti-money laundering (AML)/ counter terrorist financing (CTF) regulation on "risk-based" strategies means that regulatory, law enforcement and reporting agencies need to respond to money laundering and terrorist-financing threats in ways that are proportionate to the risks involved. However, the way that risk is conceptualized remains vague, and the requirements on agencies imposed by the risk-based approach involve a significant element of uncertainty. The paper addresses these issues.

Design/methodology/approach – This paper examines the attributes of risk as it applies to AML/CTF strategy in the context of regulatory risk and related forms of risk assessment, and argues that there are a number of conditions that must be met if risk-based decision-making for AML/CTF is to work effectively.

Findings – This paper argues that there are a number of conditions that must be met if risk-based decision-making is to work effectively. Three of the most important conditions are that there has to be agreement about what risk is being decided on; there must be explicit, quantifiable models of risk, and those responsible for developing and refining risk-based decision models must have access to knowledge about the outcomes of assessments.

Originality/value – The paper identifies the need for fundamental changes in the relationship between the regulators and the regulated.

Keywords Money laundering, Terrorism, Financing, Risk management, Regulation, Legislation

Paper type Conceptual paper

Risk and the regulation of money laundering

A central element in contemporary anti-money laundering (AML) and counter terrorist financing (CTF) strategies is the idea that regulatory efforts should be risk-based. Countries establishing Financial Action Task Force (FATF)-compliant legislation need to incorporate risk-based concepts in statutory definitions and mechanisms. Financial regulation and law enforcement agencies need to respond to money laundering and terrorist financing threats, and financial and other entities covered by AML/CTF legislation need to structure their prevention and detection efforts in ways that are proportionate to the risks involved. However, at each of these levels of AML/CTF strategy, the way that risk is conceptualized remains vague, and the requirements on agencies imposed by the risk-based approach involve a significant element of uncertainty. The move to a risk-based approach represents a fundamental conceptual shift from the previous rule-based and case-based approaches, and there are a number of theoretical and practical issues that must be resolved if risk-based strategies are to

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work effectively. This paper examines the attributes of risk as it applies to AML/CTF strategy and considers some of the issues that need to be resolved if this way of thinking to the problem of detecting and controlling money laundering and terrorist financing is to be successfully adopted.

Risk has always been integral to ways of thinking about money laundering, but it is only recently that concepts of risk, risk assessment and risk management have become central elements in AML/CTF strategies. This development is part of a general trend towards risk-based regulation arising from the "regulatory crisis" of the late 1980s and early 1990s (Hutter, 2005). Risk first appeared as an explicit AML regulatory consideration in the FATF revised Forty Recommendations issued in June 2003 (Financial Action Task Force, 2003, p. 15). Specifically, Recommendation five specifies that financial institutions should apply customer due diligence measures "on a risk sensitive basis depending on the type of customer, business relation or transaction" and that where there are low risks financial institutions can apply reduced or simplified measures, while Recommendation 24 specifies that countries should extend AML/CTF monitoring and compliance to designated non-financial institutions "on a risk sensitive basis".

Rationale for risk-based AML regulation

The idea that AML/CTF efforts should be proportionate to the risks involved is now a key element in the regulatory framework at the international, national and agency level (European Parliament and Council of the European Union, 2003; H.M. Treasury, 2004; Proctor, 2005). This change in approach to AML/CTF regulation mirrors the adoption of risk-based strategies and tools across a range of regulatory domains, and is intended to address the problems inherent in prescriptive regulatory approaches: over-regulation leading to excessive compliance costs, inflexibility and consequent poor regulatory performance, and a focus on legalism rather than regulatory effectiveness (Hutter, 2005).

A basic weakness in previous AML/CTF regulatory models has been the problem of reporting overload. It has been apparent for at least a decade that rule-based AML/CTF regulation resulted in "defensive reporting" by financial agencies, which in turn gave rise to information overload on regulatory agencies and reduced investigative capacity (Reuter and Truman, 2004). Managing the huge volumes of Currency Transaction Reports (CTRs) and Suspicious Activity Reports (SARs) generated by agencies with reporting obligations continues to be a major problem in the effective management of AML/CTF (KPMG, 2003). The extension of the AML/CTF regime to businesses that have previously been exempt seems certain to add to this problem. Risk-based regulation provides a basis for reducing the flow of reports in a way that favours those matters that are most likely to generate meaningful intelligence or a productive regulatory or law-enforcement response.

A second advantage conferred by risk-based regulation is that it provides greater flexibility and sensitivity in responding to complex problems. Prescriptive regulatory systems are constrained by their rules and guidelines, and if mismatches arise between the regulations and the risky activity, then the compliance framework will become ineffective. Rule-based regulation is particularly vulnerable as a means of dealing with money laundering where one of the objectives of the launderer is to identify weak points in the regulatory system and exploit those weaknesses. In a dynamic regulatory environment like that of AML/CTF, risk-based regulation provides a way to link detection, prevention and control directly to the activities that are the focus of regulation. Under a risk-based system, it is the responsibility of reporting institutions to "identify and assess the money laundering risks and take measures to manage and monitor those risks"(British Banker's Association, 2006, p. 129). Reporting agencies can no longer rely on establishing procedures for compliance with the AML/CTF rules. Now they must understand how their business gives rise to risks and establish strategies and procedures for responding to those risks.

The third part of the rationale for the risk-based approach is that it transfers responsibility from regulatory institutions (who previous defined the rules and case models for rule and case-based systems) to financial institutions. Under a risk-based regulatory system, the regulated entity specifies the risks that must be managed and implements the most appropriate regulatory strategies. This change in the *locus* of regulation reflects the demand for self regulation from industry and the increasing adoption of private-sector styles of management and regulation. This is a significant change in the distribution of regulatory responsibility and in the role of financial institutions and other responsible agencies in the system of AML/CTF. Regulated entities must now be pro-active agents in the mitigation of money laundering risk. Pieth and Aiolfi (2003, p. 15) note that the risk-based approach:

> . . . utilizes the professional know-how, experience and also the differentiated approach of financial institutions to understand the economic background of financial transactions and the often complex financial structures on which they are predicated.

Rule-based, case-based and risk-based approaches

In all this redefining of roles and responsibilities, the concept of risk remains elusive. Risk is sometimes referred to as a property that is inherent in places, people or products, sometimes as an outcome of financial activity, and sometimes as a property of the regulatory regime itself. Rarely, if ever, does legislation attempt to provide a definition of risk, and regulatory agencies provide few explicit criteria that can be used to differentiate high risk from low risk. As with many issues relating to AML/CTF regulation, this uncertainty mirrors a general uncertainty in regulatory theory about how risk should be defined and measured. Holzer and Millo (2004) propose that regulatory risk should be defined in terms of the way that it is associated with decision-making outcomes. Risk characterizes situations in which loss is both possible and avoidable. Knowing about the statistical probabilities associated with risk does not eliminate the necessity to take decisions, and these decisions in turn change the likelihood of future risk.

The starting point for our analysis is also to consider AML/CTF risk as a problem in decision-making. What governments ask of financial institutions is, first and foremost, to tell them when they think that money laundering or terrorist financing is going on. While some of the due diligence and identification processes in AML/CTF legislation may have the effect of discouraging criminals or terrorists from using the financial system, their primary purpose is to help financial institutions to decide whether activity needs to be reported. In the past, the AML/CTF decision models were mainly rule-based and case-based.

The FATF Forty Recommendations as promulgated in 1990 set out the basis of a rule-based AML system. There are rules that specify that certain kinds of activity are prohibited (money laundering for a range of offences, bank secrecy arrangements), rules that require certain kinds of regulatory arrangements (reporting transactions over a certain value to a central regulatory agency, border controls on cash movement) and rules that require action by agencies with regulatory responsibility (customer due diligence, record keeping, reporting of suspicious transactions). An essential element of rule-based systems is that they work best when applied to matters that are not context- or case-sensitive. That is, in a rule-based system, if something is prohibited (or required) then it should be prohibited (or required) in all contexts and all cases. Rule-based decision-making is straightforward. If something meets the conditions specified in the rule, then the action specified in the rule should be taken. Road traffic regulation is an example of a rule-based system. Exceeding the specified speed limit is prohibited in all cases and all contexts. Neither the skill of the driver, the condition of the road, nor the safety attributes of the car have any bearing on compliance with this rule.

However, money-laundering operates through the use of financial activities which are not in themselves illegal. An activity that in one context is money laundering may in another context be entirely legal. Thus, deciding whether or not something constitutes money laundering requires an understanding of the processes and participants involved in the transaction. From a very early stage, the rule-based AML regulatory framework has been supplemented by case-based analyses that "provide the necessary basis for informed decisions on AML or terrorist financing policy" (Financial Action Task Force, 2005). The essence of the case-based approach is to describe the key characteristics of distinctive forms of money laundering or terrorist financing so that other parties can detect this kind of activity. Case studies are examples of specific instances of money laundering , while typologies are intended to be prototypical descriptions, representing the essential elements in an ML method. The elements of a typology may include the source and destination countries, predicate offences, financial sector and specific mechanisms used. More recently, FATF has begun to develop a generalized conceptual framework for classifying ML methods in order to better understand changes in ML methods over time (Financial Action Task Force, 2005).

Case-based decision-making is exemplified by decision processes like clinical diagnosis and judicial sentencing (Tata, 1997). These forms of decision-making involve a process of pattern matching. The decision maker needs to be able to examine the complex patterns of information in individual cases and determine whether they match the features of an idealized type case. Decision makers engaged in this kind of behaviour frequently make use of schemas – simplified cases that incorporate the most important features that bear on the decision. A key feature of these forms of decision-making is that they are "expert" behaviours. Case-based decision-making requires a detailed, expert knowledge of the problem area of concern, the ability to process a lot of information simultaneously, and the capacity to recognize and select critical diagnostic or judgment features.

Risk-based decision-making involves ways of considering information in order to reach a judgment or decision that are quite different to rule-based or case-based decision-making. Risk-based approaches are widely used in a variety of regulatory and enforcement environments. Police use risk based models to decide when and how to intervene in family violence situations. In the finance industry there are a range of risk-based models to identify credit risks and various forms of fraud corrections agencies use risk-based assessment for deciding what kinds of program interventions should be delivered to convicted offenders. All of these forms of risk-based decision-making are concerned with artefact risk – risk that is objectively knowable and amenable to probabilistic calculation (Kemshall, 2003). Another common attribute is that decisions about the management of these risks are made in situations where at least some components of risk are unknown or uncertain.

Risk-based decision-making requires that we understand the way that specific attributes of the problem space contribute to risk. Unlike case-based decision-making, where in effect we are asking "does this combination of client and transaction attributes match a known pattern associated with money laundering?" a risk based approach requires that we have a probabilistic model that shows how specific attributes of the problem space contribute to the probability that money laundering is present. The problem space for money laundering includes the same elements that we would be concerned with in a case-based approach – the pattern of transactions, the nature of the participating parties and a variety of other intelligence that we might have about the situation.

If we consider how risk-based decision-making works in other contexts, it can be seen that there are a number of conditions that must be met for effective, reliable decision-making. Three of the most important conditions are:

(1) There has to be agreement about what risk is being decided on.

(2) There must be an explicit, agreed model of the attributes that will contribute to the assessment of risk.

(3) Those responsible for developing and refining a risk-based decision model must have access to knowledge about the outcomes of assessments.

Defining risk in money laundering

The effectiveness of risk-based regulation depends on the regulated agreeing with the regulators about what risks need to be controlled and the manner of control (Stewart, 2005). The concept of risk in relation to money laundering involves at least three distinct elements. The first concerns the strength of the relationship between the attributes that one observes and the event that one wishes to identify or detect. This form of risk can be described as probabilistic risk. Where a strong relationship exists, one can say that a high level of risk is present. For example, if we know that money laundering or terrorist financing is almost always associated with identity fraud, then the presence of identity fraud indicates a high level of risk. A second way of conceptualizing risk is concerned with the potential seriousness of the events to be detected (consequence risk). It makes sense to give more attention to accounts that involve high cash flows than to those that where the cash flow is small, or where one form of risk-associated activity provides the basis for other undesirable outcomes such as providing funding for further crime. The reputational risk associated with being identified as having failed to detect or report money laundering or terrorist financing is a form of consequence risk. Finally, risk can also be about vulnerability. If there are elements of an agency's business that are known to be difficult to monitor, or that are more likely to be the subject of an attempt to subvert them, then these elements can be thought of as constituting a higher degree of risk (regulatory risk).

A risk-based AML/CTF strategy must consider all of these forms of risk, although the emphasis placed on them may vary depending on where one stands in the regulatory system. A large corporation may give greater weight to detecting activity that carries a significant reputational risk. Law enforcement agencies may wish to focus on activities that are associated with important predicate crimes like drug trafficking. For regulatory agencies, vulnerability (regulatory risk) may be more important. In the UK Financial Services Authority regulatory model, the factors leading to increased enforcement attention include weaknesses across entire divisions or branches within an organization, multiple breaches within an organization, or a failure to take remedial action following failures or breaches. Enforcement is "targeted at the systems and control failures that pose the greatest risk" (Proctor, 2005, p. 12).

An important consequence of transferring regulatory responsibility to financial institutions is that they already have considerable experience in the management of risk. This is advantageous in that they have access to expertise and tools that can be applied to the problem of money laundering. However, it is also likely to mean that risk-based decision practices and values that have been developed to deal with other forms of risk will be applied to money laundering. Thus, it cannot be assumed that financial agencies and regulators will approach the problem of risk assessment and risk management from the same perspective. While financial institutions are readily able to make assessments about credit and fraud risk, assessing the money laundering risk in financial terms in notoriously difficult. Existing systems for assessing risk associated with fraud and credit are based on their potential financial consequences. However, in the case of money laundering and terrorism financing, the important risks are not those of financial loss to the institutions or the integrity of the financial system in general, but rather the risks to the community that flow from the failure to prevent these activities (McCusker, 2005).

The elements of a risk assessment system

Risk models work best when they are explicit and consistently applied. The essence of artefact-risk assessment is the replacement of idiosyncratic judgments with systematic processes that generate replicable outcomes (Kemshall, 2003). If financial services agencies are to implement risk-based AML/CTF strategies in a reliable and consistent manner, then there needs to be agreement between the regulators and the regulated about what the elements of a risk assessment system should be, and this in turn needs to be based on an understanding of how different forms of financial activity give rise to risk.

Developing explicit risk assessment systems for money laundering and terrorism financing poses a number of distinctive problems. Unlike many other areas of criminal justice risk assessment, money launderers and terrorism financiers are active and responsive agents that seek to identify regulatory strategies and find ways around them. Any AML/CTF risk assessment system needs to incorporate this problem as a source of risk in its own right. The strategy of looking for transaction amounts just below the reporting threshold is an example of how risk assessment systems can deal with this kind of responsive risk. A related problem is that the dynamic nature of ML/TF activity means that risk assessment systems are likely to have a limited "shelf-life" and will need to be continuously updated to take account of new methods or changes in the sources of risk. Stewart has noted that making risk assessment systems explicit involves potential drawbacks for regulators, one of which is that explicit systems are open to critique and must therefore be defensible (Stewart, 2005).

A second problem for risk model development is that as the regulatory environment becomes more complex, so do the demands on risk assessment models. The challenge for regulatory authorities is to maintain a consistent approach that is at the same time sensitive to the variations in risk across different sectors of the financial system. For example, the nature of risk is likely to vary greatly depending on the kind of business carried out by a reporting institution. The extension of AML/CTF responsibilities to small firms is an issue of particular significance is this respect. Most regulatory strategies equate the level of risk with institutional and transactional size – a form of consequence risk. The amount of reporting information that is required depends on the institution's size, location and customer base, and the customer's size, location and type of business, and the services offered to the customer (Reuter and Truman, 2004). However, there is little reason to suppose that large customers are inherently more risky than small ones, or large institutions are more likely to be targeted than small ones. If vulnerability risk is a primary source of AML risk, then it may be more productive to target regulatory resources at smaller institutions and smaller customers.

Knowing about outcomes

Knowing about the outcomes of risk-based decisions is critical to the development and refinement of risk assessment systems. Ideally, assessment systems should be developed using data from a large pool of actual cases, the predictions made by the system should be tested against observed outcomes, and the information gained fed back to further refine the accuracy and reliability of the system. The value of different risk assessment systems can be judged in terms of their predictive power, and the potential effectiveness of more or less intensive regulation can be judged in terms of the increase in predictive power relative to the costs of achieving that increase.

Where AML/CTF systems are concerned, there are two fundamental barriers to knowing about outcomes. The first is that many (perhaps most) of the outcomes of ultimate interest are unknown. In the case of offender assessments, it is usually possible to know with a reasonable degree of accuracy whether the offender was charged or convicted of further offences, and the timing associated with these events. For credit risk assessments, a business may not know about the outcomes of individual cases, but will at least know whether the level of bad debts is increasing or decreasing. However, for AML/CTF systems there are relatively few ultimate outcomes. Only a small minority of suspected cases result in active investigation, and an even smaller proportion are proven in court. Additionally, the focus of law enforcement tends to be on investigating and prosecuting the predicate crime and not the money laundering activity directly. Therefore, it seems likely that cases where an outcome is known are unrepresentative (that is, we know about them because of features that distinguish them from ML/TF cases in general).

A second problem is that the system of AML/CTF reporting and enforcement means that the agencies responsible for identifying suspected cases almost never find out whether their suspicions were justified. While regulatory agencies do see they have a responsibility to provide feedback on risks, this is usually in the form of advice about general patterns or trends. There are also systemic reasons why feedback is rarely or inconsistently provided including differing operational priorities, the long periods that are likely to elapse before outcomes are known, and organizational or information technology barriers within regulatory and enforcement agencies (Fleming, 2005).

Reuter and Truman (2004) have argued that there should be a database of detected money laundering transactions created that would be available for research. This database would be based on the results of investigative decisions, and include details of predicate offences, prices paid to launderers, the transaction processes and the characteristics of the customer and provider. Their proposal highlights the need for feedback loops as an integral component of a risk-based regulatory system in order for that system to be informed and refined, especially as the risks that are to be identified and managed are not limited to risks derived from known and identified methods of money laundering.

Conclusions: developing risk-based AML/CTF systems

While the concept of risk has always been a part of responses to money laundering, the new AML/CTF regulatory strategy places risk at centre stage. Risk is the metric that will determine the way that financial agencies structure their monitoring and reporting activities, and regulatory and enforcement agencies allocate their resources. Risk-based regulation holds the promise of being more efficient and effective than rule-based regulation, but it also brings with it potential disadvantages. The effectiveness of the new AML/CTF strategy will be judged according to how well it targets high risk activity while at the same time avoiding putting barriers in the way of legitimate financial active. These changes involve a significant departure from existing practice, and require that risk is conceptualized and analyzed in much more concrete terms than in the past.

In this paper, we have tried to show how the concepts and principles of risk based regulation and risk assessment can be applied to the specific requirements of AML/CTF. A key issue that emerges from this analysis is the need to understand the attributes of risk as they apply to money laundering and terrorist financing. Risk is a property that in the first instance emerges from the activities that generate the illicit funds and the applications of those illicit funds to crime and terrorism. Risk assessment and detection systems that will support the new regulatory approach must be based on a comprehensive understanding of these activities. A key challenge for criminology is to move from seeing money laundering and terrorist financing as consisting of generic or archetypal cases, to understanding them as dynamic and purposeful activities that are informed by distinctive bodies of knowledge, expertise and practice.

Beyond the mainly technical and conceptual challenges of developing AML/CTF risk assessment systems and the move towards a regulatory approach that is based on risks rather than compliance with rules, we also see a need for fundamental changes in the relationship between the regulators and the regulated. Our analysis suggests that one of the critical requirements for effective risk-based AML/CTF systems is communication and information sharing between the regulators and the regulated. The starting point for this process is clarification of the meaning and interpretation of key elements of the regulatory environment: what risks financial agencies are to be responsible for identifying; the priority to be given to different sources of risk; the customer, transaction and service factors that will inform judgments about risk, and the manner in which these risks should be mitigated. There needs to be provision for reporting agencies to be provided with systematic feedback on the outcomes of the things they report in order to "close the information loop". Finally, there probably needs to be sharing of information about the structure and operation of quantitative risk models.

A series of reviews of the AML/CTF regime in the UK have pointed to the need for more detailed exchange of information between law enforcement agencies, regulatory agencies and financial institutions (KPMG, 2003; Fleming, 2005; Lander, 2006). The benefits claimed for improved feedback and communication include more effective matching between the content of SARs and LEA information requirements, improvements in the quality of SARs, and improvements in the general performance of reporting agencies. The potential problems arising from inadequate information sharing may be particularly acute as the scope of AML/CTF regulation expands to cover large numbers of small and medium sized businesses that have little capacity to invest in the development of sophisticated risk assessment systems. The consequence may be that different agencies will operate fundamentally different risk assessment systems. This is a situation that is unlikely to generate consistent outcomes, or engender public confidence.

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